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REEL TIME

SPECIAL REPORT

Presented by Verle Sutton

SCA AND COATED FORECAST FOR 2016: "Because We Can"

THE YEAR IN REVIEW — U.S. GOVERNMENT REGULATORY AGENCIES REIGN SUPREME

Introduction

This is not a political report; I try to avoid politics. In the early years, the subject of politics was touched on only when economic policies were discussed. Even then, I tried to be non-partisan.

However, politics, from an economic standpoint, have been chasing those of us who tend to fear the huge economic costs and social ills that come intertwined with big government and big government programs. Once or twice a year, a few pages are devoted to this subject.

More importantly, the problem for us at *Reel Time* is that the U.S. government has now become highly intrusive in the paper business. The paper business was supposed to be ours, not theirs. Now that the U.S. government has become the dominant factor in the printing papers business, politics cannot be completely avoided. You might be okay with this government involvement — you may even benefit from it — but what you will read about in this report is more disturbing to me than I can possibly put into words. However, I will try.

Since I show no mercy to the U.S. government in this report, I feel the need to offer a paragraph of balance. Just for the record, I have always been a patriot. I believe the U.S. has been a beacon of freedom during at least the last hundred years. It is true that most other countries tend to hate us, but rarely for legitimate reasons. The "Greatest Generation" was truly that: the greatest generation. The Allies saved the world from Nazi domination. Our help in rebuilding Japan and Germany (and even much of the rest of Europe) after the war was, I believe, historically unprecedented. In Korea and even Vietnam, our actions were not taken to add territory or gain financially in any way; they were sacrificial. More than any other nation, the U.S. has attempted to assist others in need, through the government and particularly through private, faith-based charities.

Thus, I am very proud of where we have been as a nation, and the progress the U.S. has made. On the other hand, in recent years there has often been an absence of a basic, ethical, common-sense code in law and government. As well, the growing control and shaping of society through the court system, the health care system, federal government agencies, and big government in general has taken a toll and is very frightening.

I was sitting in a dentist's office not too long ago and began talking to a woman who had emigrated to the U.S. from Poland some forty years ago. She still had an accent. After we had talked for a few minutes about her life in the United States, she said, "When I came to this country I was so, so proud to be an American. Now, not so much."

(continued)

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Government is the Dominant Market Factor

The entire emphasis of this annual forecast issue should be on the difficulties associated with rapidly declining SC/coated paper demand and the strong U.S. dollar. Paper market conditions are beyond very difficult: we are witnessing (and many readers are experiencing) a war of attrition. The specifics of this war of attrition will be discussed later. Unfortunately, as mentioned earlier, U.S. government interference is now the most dominant "market factor" of all, so the discussion of that intrusion must play a central role in this report.

Environmental Issues: Until late 2008, federal and state involvement in the paper business was generally limited to real and/or imagined environmental problems, as well as to costly and continuously expanding regulations of all kinds. It is, of course, important to address actual environmental risks and concerns, but the federal and state governments often go far beyond what is necessary. Government bureaucracies, and most of our elected representatives, are simply not concerned with the cost impact of the policies they impose on businesses — **policies that make U.S. manufacturers less competitive, increase imports, export manufacturing jobs offshore, and increase prices to U.S. consumers.**

And that beat goes on. New EPA Boiler MACT regulations that further limit permissible emissions become effective on January 31, 2016, and these regulations could lead to mill closures by early in the new year. Reports indicate that several mills (and at least a couple of coated mills) do not meet the new, extreme standards. These mills can petition for a one-year extension and it would be granted if the company can convince the EPA it would be able to make the necessary investments in 2016. However, do marginal manufacturing operations have the funds set aside to cover what I would expect to be multi-million-dollar expenditures? And if they don't have the money, who would lend it to them? And if they did manage to get a loan, that new debt load would significantly increase their non-operating costs, thereby decreasing corporate viability.

What's more, even before the EPA Boiler MACT regulations go into effect, the next battle against U.S. manufacturers has begun. The EPA recently decided to lower ozone standards again. The following is from an AF&PA news release:

EPA's decision to tighten the ozone NAAQS standard was misguided, and we are disappointed by their action. Air quality is continuing to improve as a result of the billions of dollars of new investment currently being made under existing program implementation. Public health is protected at 75 ppb, and the full weight of the scientific evidence does not support a further tightening of the standard.

AF&PA will work with its members to encourage states and EPA to implement the new standard in as flexible a manner as possible under the law. We wish that EPA had allowed states to finish what they already started before heaping new and unnecessary regulations on an industry such as paper and wood products manufacturing facing global competition. We will also be considering our industry's options to minimize the blows of continued overregulation.

The New Heavy Hand of the U.S. Government: Unfortunately, since late in 2008, the many tendrils of the U.S. government have spread dramatically. It began with the black liquor billions — about $25 billion in all. (See our update in the May 2015 *Reel Time* and on page 9 of this report.)

The DOC then decided that U.S. printing paper producers (actually, only selected grades) needed government protection. The first action put the kibosh on coated free sheet, sheet-fed grades from China and Indonesia. That was, in fairness, understandable. The Chinese government tends to protect its domestic market with high tariffs at the same time as it subsidizes Chinese exporters.

In 2014, government intrusion escalated, as shown by the manner in which the Verso–NewPage review was handled by the Department of Justice (DOJ). And then, in 2015, the Department of Commerce (DOC) blasted offshore uncoated free sheet imports from multiple countries, as well as Canadian SC imports.

These issues have been covered regularly this year, but there is new information on all three of these matters. However, three full updates in this already long report would be too much for anyone to bear. Therefore, Verso's status is reviewed and a full SC update is provided, but the uncoated free sheet market will just be touched on, with only basic facts and limited commentary provided at this time.

The New Verso Paper

The Verso purchase of NewPage was announced at the start of 2014 and was finally concluded at the beginning of 2015. The DOJ took its sweet time about it; the Bucksport, ME mill was closed during the waiting period (Q4/14). In the end, the DOJ required that Verso give its Rumford, ME and Biron, WI mills to some other company; Catalyst was the "winner" (at least it took possession of the two mills; whether this was a winning move or not seems to still be in question).

Catalyst was required to audition for the part. The DOJ was not going to let just any company take over these mills. Catalyst had to jump through the DOJ's hoops and prove that it was a quality paper operator with adequate resources (as if the DOJ really has any idea of how to manage a paper company). Nevertheless, Catalyst passed the test and suddenly became the largest coated groundwood producer in North America (see the tables that follow; they include the recent capacity reductions announced by Verso at its Jay, ME and Wickliffe, KY mills, as well as the closure of Catalyst's Rumford PM#12).

Proposed (Q4/15) N.A. Coated Mechanical Capacity • By company

Company	000 tons	Market Share
Catalyst	860	30%
The new Verso	665	23%
Resolute	550	19%
UPM	390	13%
Kruger	275	9%
Evergreen Packaging — Pine Bluff	180	6%
	2,920	**100.0%**

Proposed (Q4/15) N.A. Coated Free Sheet Capacity • By company

Company	000 tons	Market Share
The new Verso 78%	1,770	46%
Sappi	1,240	32%
Appleton Coated	390	10%
Catalyst	200	5%
West Linn	250	7%
	3,850	**100.0%**

The long delay in DOJ approval and the fact that Verso and NewPage ignored (for several months) a price-increase opportunity that should have been taken advantage of in Q4/14 were very costly for Verso, and pushed the company to the brink of bankruptcy sooner than would have been the case had the DOJ acted reasonably.

Yet the Verso/NewPage Deal is Still Not Complete:

If the description of government activities taking place in 2015 were written as part of a fictional story, it would never be published because it would be far too unbelievable.

The indented passages shown below and some of the other factual material are from an August 24 story in the *Portland Press Herald*, written by Whit Richardson.

For background, it turns out that the DOJ filed a complaint on December 31, 2014, right before it allowed the Verso deal to go through. This complaint, in effect, made the DOJ approval conditional on specifics of the agreement between Verso and the DOJ being met in the future, and opened the door for other litigation even if Verso and Catalyst lived up to the agreement. As such, this conditional approval allowed opponents of the Verso purchase of NewPage (which I will refer to in the future as a "merger" in order to reduce how many words I need to type) to object. And — surprise, surprise — that is what occurred. Kim Tucker, an attorney hired by Local 1821 (a union that represented some of the workers at the closed Bucksport mill) has filed suit.

The complaint apparently does not suggest that the agreement has been broken by Verso or Catalyst. The attorney (Kim Tucker) apparently just believes the following:

> *...the DOJ's requirement that NewPage sell its mills to Catalyst "has already been demonstrated to be an ineffective and unreasonable remedy to 'cure the antitrust violations alleged in the complaint.'"*

So, in other words, the complaint is really just taking exception to the DOJ's decision in the first place.

In a letter to Judge Tanya Chutkan, Tucker makes the following claim:

> *...the Bucksport closure, coupled with other events since Verso acquired NewPage, including recent layoffs in Rumford, a price increase for Verso paper and last week's announcement that Verso would shut down a paper machine and pulp dryer at its Jay mill, are proof that the DOJ's agreement did not protect the public interest.*

In my opinion, this suit and this analysis are without merit. Obviously, then, the judge would throw the case out of court. Well, no, not in 2015 America. On August 24, the judge said she would hear challenges to the Verso purchase of NewPage.

Catalyst and Verso/NewPage had submitted responses to the lawsuit prior to the judge's decision, and these explanations seemed very persuasive to me. However, the judge was not moved.

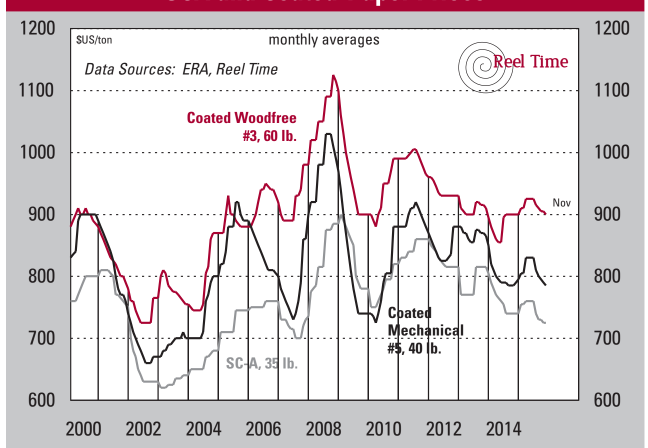
I am not going to take the time to refute the lawsuit point by point. A ten-year-old could subtract current coated shipments from the 2006 level and conclude that it is not possible to keep running paper machines that are no longer needed and are creating enormous financial losses for their owners.

Pricing and the Lawsuit Challenging the Merger: I do want to address two aspects of the lawsuit. The first is pricing. I have found that news reporters, and I suppose the general public as well, tend not to understand how pricing works in paper or other commodity-based industrial companies. As a result, they viewed that coated-paper price increase early in 2015 as a bad thing, and a result of the Verso takeover of NewPage.

Well, first off, coated pricing throughout 2014 was historically very low — even below what most analysts believed was the cash-cost bottom for high-cost mills. **In other words, most analysts would not have believed (in 2013) that coated pricing could possibly have remained as low as it did in 2014 without closures occurring and, later, prices bouncing up.** That 2014 level of pricing is in the "death zone." It is like being at 29,000 feet on Mount Everest, i.e., you can survive for a while, but you can't live there. Prices had to go up. (And, by the way, we are back in that death zone.)

Those of us with any significant experience in the paper business understand that, since the secular decline began, the only way prices will rise is if supply is reduced enough to balance supply and demand (really, to balance supply and shipments). Therefore, it is absolutely true that when capacity is shut down and supply and shipments are balanced, prices go up. So, yes, producers were very anxious to raise prices when FutureMark and Bucksport were closed. They needed a breather, and it was too bad they did not get it in late Q4/14 rather than at the start of Q2/15. As a result of Verso and NewPage sitting on their hands throughout Q4/14 to mollify the DOJ, most of the increase was not in place until Q2 — and then the increase lasted only three measly months. Unfortunately for paper companies in today's world, supply and shipments don't remain balanced for very long. Those coated price increases from early 2014 have already been erased (see the next graph). What's more, unless capacity is reduced soon and substantially, prices will be even lower by January.

SCA and Coated-Paper Prices



"To Protect the Public Interest": Second, the DOJ's intransigence it its dealings with Verso did not further the public interest, but instead set it back dramatically. All U.S. paper companies have been financially weakened as a result. This allows imports to become a greater factor and will result in U.S. mill closures sooner than would have been necessary. The new Verso was never going to be successful in the long-term, but if the DOJ had allowed Verso to go through the process quickly and in whatever manner it chose, the company would have lasted longer.

This "to protect the public interest" phrase is quite disturbing. It should not be up to the DOJ or the courts to decide what is economically in the public interest. They tried public planning in Cuba, North Korea and Russia. Companies never shut down in the old Soviet Union because this was never in the "public interest." The courts have a responsibility to uphold the law in a reasonable, ethical manner — that's all. The free enterprise system will work if it is allowed to.

If the DOJ, or Kim Tucker's union, or the U.S. government, or the State of Maine want the paper mills in Maine to keep operating, then they should put in an offer to buy the next mill slated to be closed. If would be fun to see how any of these entities perform as paper-mill operators in 2016.

"Verso Wielding Too Much Influence": The lawsuit challenging the DOJ ruling states that the DOJ made it too easy for Verso to obtain its merger with NewPage. The lawsuit makes the following claim:

> *...the closures are the result of Verso wielding too much influence in the North American market for coated paper and seeking to earn higher prices for their coated paper after cutting supply.*
>
> — This statement is from a passage in an Industry Intelligence reprint of an August 25, 2015 *Bangor Daily News* story on this subject, authored by Darren Fishell

Really? Too much influence? Your Honor, there is an elephant in the room. Verso's stock has been delisted from the NYSE and is now trading at $0.09/share. First-lien Verso bonds have lost more than 75% of their value in 2015. The 11.75% coupon now has an effective yield of nearly 50%. The remaining value of these Verso bonds does not spring from the expectation that interest payments will ever be received, but from the ownership of the pulp and paper assets that will revert to first-lien bondholders upon bankruptcy.

This is the same company that the lawsuit contends has used the merger to control pricing and supply and, by implication, to enrich itself! I don't think so — at least not the corporate entity of Verso.

Nevertheless, oral arguments were presented before the judge on September 1. To my knowledge, she has not yet ruled. What would happen if the judge declared the merger null and void? Well, we are already partway down the rabbit-hole — just hanging on to the lip — and if you look down you can see Alice waving at us. That ruling by the judge could send us all the way down.

The SCA Trade Case

Introduction: This summer I read *The Heart of Everything That Is*, by Bob Drury and Tom Clavin. The book provides an historical account of the American Indian wars in the middle of the 1800s, primarily covering Red Cloud's Sioux nation (Red Cloud was an Oglala Lakota Sioux). It is a balanced book in that it does not glorify or condone the horrific actions of either the native American Indians or the U.S. government. Nevertheless, I found myself rooting for the Indians. (Perhaps that is due to the remnant of American Indian blood that I carry: my great-grandmother, about nine generations back, was a full-blooded Cherokee. Betsy Sutton was born about the time of the American Revolution, and died while being transported to Oklahoma during the Trail of Tears in the mid-1830s.)

The authors contend that Red Cloud's coalition in the 1866–1868 war (referred to historically as Red Cloud's War) was the only Indian group that actually won its war with the United States, forcing the U.S. to secure peace on Red Cloud's terms (which were primarily to go away and leave them alone).

However, it was a short-lived victory. The U.S. never honored its agreements with the Indians. In 1875, Red Cloud visited Washington, DC to try to convince the U.S. to live up to the 1868 Treaty of Fort Laramie that had ended the war. He had no luck.

As the tale goes, Red Cloud spoke with President Grant during a White House reception. He tried to explain the crucial importance of the Black Hills region to the Sioux, emphasizing that his ancestors' bones lay there. Grant was not moved, and corrected Red Cloud's version of history:

> *"... your people have been there no more than a couple of generations. They come from Minnesota, and you were born in Nebraska. You took that land from the Crows. And do you know why you took that land from the Crows? Because you could."*
>
> *"And do you know why we will take that land from you? Because we can."*

Protective Tariffs: Protective tariffs are considered one of the key factors that caused, deepened and lengthened the Great Depression. Perhaps that is why our political leaders were consistently reluctant to play the tariff card during the seventy years prior to the Obama Administration. This was commendable. Negotiations were preferred. These negotiations often left the U.S. at somewhat of a disadvantage, but we could deal with that.

However, recent years have changed everything. The explanation the DOC offered (to one of the Canadian companies involved) about why the DOC could not investigate Irving Paper and Catalyst Paper was that it *just did not have time*. There were 140 trade actions in progress!

These are cases that were introduced to the DOC through pressure from Washington politicians. To the degree that DOC cases are resolved to the satisfaction of their constituents in those political districts, these politicians tend to keep their jobs and, at the same time, become indebted to the Administration.

It is a travesty, but the aggressive actions of today's DOC and Congress have pulled the U.S. back to where we were in 1875. We are back to taking things that belong to others, *because we can.*

The Final SC Subsidy Rates: As you know by now, the DOC's final verdict was a 20.18% duty for Port Hawkesbury, a 17.87% duty for Resolute, and 18.85% duties for Irving and Catalyst.

The ITC will rule on or about December 4 whether or not imports of SC from Canada "materially injure, or threaten material injury to domestic SC producers." Based on the way political winds are blowing, it seems likely the ITC will be just as unfair as the DOC has been. If that is the case, all four companies will be stuck with those duties for an extended time.

From what I understand, it will be a full year (from the time of the ITC confirmation) before Port Hawkesbury or Resolute can even ask for an administrative review. Then it would take another twelve to eighteen months for that outcome to be known. Appealing to the World Trade Organization and/or NAFTA are other options, but it does not appear that these organizations have the power to change U.S. policy — at least not within the next two years.

Irving and Catalyst will apply for, and likely receive, an "expedited review" since the two companies were never investigated in the first place. However, this *expedited* review will still take nine to twelve months.

Port Hawkesbury: This mill did receive substantial financial support from the Province of Nova Scotia, so some kind of duty was not unreasonable (see the September/October *Reel Time* for more details). Nevertheless, of the 20.18% final duty, about 70% was related to an energy deal with a private utility. Port Hawkesbury and Canadian officials contend that a business agreement between two companies is not within the scope of any investigation of subsidies. The DOC disagrees, and Port Hawkesbury cannot immediately appeal to any other entity.

Giles Gauthier, a senior official at the Canadian embassy in Washington, told a Commerce hearing that the ruling would allow foreign companies to retaliate against U.S. companies that also do deals to secure cheap power. "If not corrected, this will create a dangerous precedent," he said.

Resolute: **The preliminary duty for Resolute was increased from 2.04% to 17.87%.** This was, of course, the bombshell that came with the DOC final duty ruling. The official explanation follows.

In the final ruling, actual subsidies were reduced from the 2.04% preliminary duty to only 0.77%. Since that 0.77% is less than 2%, Resolute would not have been required to pay any subsidy at all.

This 0.77% of subsidies was based on two small programs that a pulp subsidiary of Resolute (Fibrek Inc.) was able to take advantage of. The DOC ruled that since a small amount of pulp from this subsidiary was used to produce SC paper, then it was an SC subsidy.

So where did the other 17.1% in duties come from? The DOC claimed that Resolute did not fully cooperate with its investigation. **As a result, it chose to penalize Resolute 8.55% for each of the two small subsidies.**

Resolute strongly disagreed with the DOC claim; it said it cooperated fully. However, Resolute has no place to go to appeal, or more importantly to have some unbiased mediator look at the two positions and make a decision. The DOC is not all-knowing, but it is all-powerful.

Irving and Catalyst: These two companies, which were never investigated, will pay subsidies of 18.85%. This is equal to the average of the penalties imposed on Resolute Paper and Port Hawkesbury.

It is interesting that the U.S. government agencies refer to these SCA duties as "subsidy rates." The fact is that, of the duties assigned to Resolute (17.87%), Irving (18.85%) and Catalyst (18.85%), only 0.77% was attributed to alleged subsidy infractions.

Attack on Canada: Canadians tend to consider the other person's point of view no matter how ridiculous it is; that is a part of their culture and they are proud of it. However, there are exceptions to this rule, and it is safe to say that this DOC decision on SC grades is one of them.

Even if Resolute had not been fully cooperative (and I am not suggesting this was the case), a penalty of 23 times the actual subsidy level assigned is just unfair. Regrettably, the DOC can do whatever it wants.

Moving from Resolute to Irving and Catalyst, there is obviously no excuse for not investigating these companies when the possibility of such high, financially destructive duties existed. And, regardless of what the rules are, there must be ways to override official rules in order to prevent the injustice that Irving and Catalyst now face. If nothing else, an executive order could have been requested.

The only logical conclusion is that there is something very wrong with this entire process.

What Will Be the Canadian Response?: Canada is limited in how it can respond to U.S. aggression. It is an exporting nation dependent on the U.S. market. I assume that the DOC rulings are creating a great deal of angst in Canadian political circles, but I would not know that given the absence of political outrage.

Canada needs to come up with a response or this unfairness will crop up in other places. I can think of a number of possible national responses, but all require leadership and most require sacrifice, so nothing will happen unless Canada's leaders becomes as angry as I am. What the U.S. has done, in effect, is to show disrespect to a friendly nation.

There are times when principles are more important than prosperity.

The Financial Impact: The next table summarizes the financial impact of the duties. The United States, because it can, will confiscate about $141 million (U.S. dollars) from these four companies over the next twelve-month period.

One would think that both Irving and Catalyst will get their money back in nine to twelve months, but after the Resolute ruling that is no longer a foregone conclusion.

I am not certain, but I think Port Hawkesbury and Resolute will get their money back if they win their individual administrative reviews. However, there is certainly a risk here for both companies. Even if one or both get some or all of their money back, it would likely take at least two years and probably longer. There is a big expense and uncertainty cost inherent in that wait even if there is an eventual positive outcome.

Now that the new CVDs are in place, Port Hawkesbury may be able to cover its cash costs, but I don't think any of the other mills will be able to do so. Even though all of these companies claim they will continue operating, closures are possible. In fact, if the Canadian dollar picked up strongly versus the U.S. dollar, closures would be a certainty.

CVDs on Canadian SCA Producers

Company	Preliminary CVD Rate	Final CVD Rate	Cost/Ton (US$/est.)	Annual Cost (US$ millions/est.)
Port Hawkesbury	20.33%	20.18%	$140	$50
Resolute	2.04%	17.87%	125	25
Irving	11.19%	18.85%	135	50
Catalyst	11.19%	18.85%	125	16

Note: The cost/ton and annual cost estimates are based on the final CVD rates and very rough estimates of grade mix and pricing. These estimates could also change to the degree that Canadian producers decide to produce more high-bright grades and less SC.

It is likely that these four companies will attempt to shift as much business as they can to super-bright grades, but a big shift away from SC is not likely. This effort, however, will make it even more difficult for other super-bright producers.

Uncoated Free Sheet Trade Case

Billions in U.S. government handouts were not enough. (Page 9 is a partial reprint from the May 2015 *Reel Time*.)

The Chosen Ones (the kraft pulp and uncoated free sheet producers) have once again been blessed and protected by the federal government. IP and Domtar (with a little help from GP and Boise) have been able to control uncoated free sheet market prices for the last decade. This has been accomplished by proactively taking out capacity in order to keep supply and demand balanced, a strategy that Verso apparently has no right to consider. These uncoated free sheet prices — especially cut-size — have been very high and extremely profitable for uncoated free sheet producers, although costly for U.S. consumers. (Also see *Reel Time* report from October 2014.)

It is beyond ironic that, at the same time the Verso merger is being challenged in court — based largely on a small coated price increase that lasted only three months (while coated prices were historically low and unprofitable) — the DOC is protecting the very high pricing that uncoated free sheet producers have enjoyed for a decade.

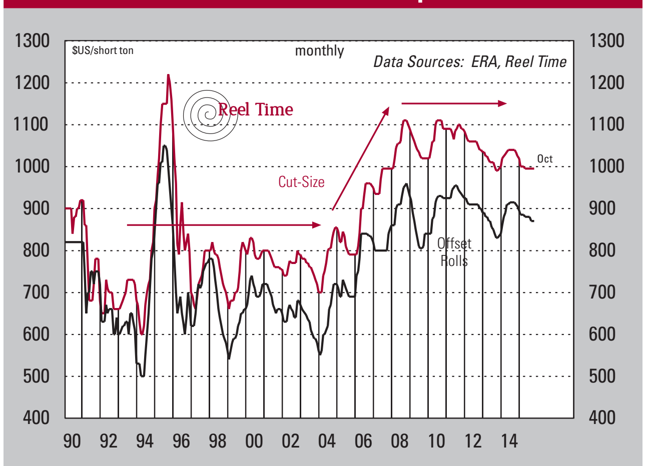
Every analyst comment I saw following the DOC's announcement of uncoated free sheet ADDs expressed surprise — surprise bordering on shock and amazement. The DOC determined (preliminarily) to apply ADDs starting at 29% and going up to infinity (well, not really *infinity*, but up to 193%).

It seems obvious that the intent of this investigation was to find cause for high tariffs/duties in order to protect the high profits of U.S. companies. The problem is that Europe, Australia, Brazil and others will get even with us when they have the chance. World trade is in the process of being reduced by the U.S. government, and we will all be the poorer for it.

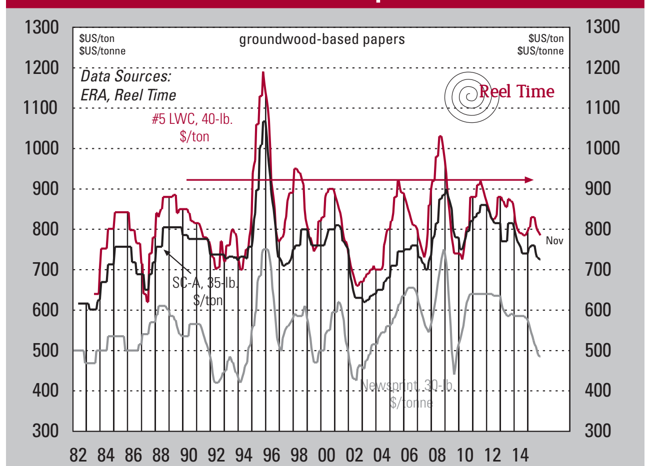
At another time, we will provide an update on uncoated free sheet. At present, it is enough to know that there will be pressure on cut-size uncoated free sheet imports. This pressure will result in new import players coming on the scene, and will open the door to possible new competitors. ●

— *Verle Sutton*

U.S. Uncoated Woodfree Paper Prices



U.S. Publication-Paper Prices



See the two graphs above. Note in the left graph how much higher prices of uncoated free sheet have been since 2006 — on average about $200/ton higher than in the previous fifteen years. These higher prices resulted from effective supply and then price control. Proactive mill closures of uncoated free sheet made this price control possible.

If consolidation had not been allowed in uncoated free sheet grades, this strategy would not have worked and prices would have remained (cyclically) flat — as has been the case in newsprint, SC and the coated grades (see graph at right).

With offshore imports now being pushed out of the U.S. market by the DOC duties, the uncoated free sheet producers will be able to continue their strategy of supply and price control.

— *Reprinted from May 2015* Reel Time

BLACK LIQUOR CREDITS

The previous review sets the stage for the involvement of pulp and paper companies during the free-money hysteria of 2009. Nearly all of you are familiar with the black liquor tax credits, so only a summary follows. If it is not familiar, you can read about this amazing and depressing story in "Less Than Free Enterprise" from November 2009: http://suttonpaperstrategies.com/PDFs/Nov09%20RT%20Less%20Than%20Free%20Enterprise%20Special%20Report.pdf.

In a nutshell, about $8 billion was to be paid out to pulp companies and paper companies (that produced kraft pulp) in 2009 at the time I wrote that report (see the two tables at right). However, that was only the beginning; the program continued in marginally different variants. The *Dead Tree Edition* quotes an IRS whistle-blower who estimated that black liquor payments over the last six years reached about $25 billion — $8 billion in 2009 and then another $17 billion in the ensuing years! Also according to *Dead Tree*, the program finally appears to be winding down (http://deadtreeedition.blogspot.com/2014/11/black-liquor-hangover-us-paper-industry.html).

These funds were a completely undeserved windfall. The U.S. government has been sending these companies *your* tax dollars. The money you worked so hard for was frittered away for completely political purposes (note: the word "frittered" was a second choice).

To obtain your tax dollars, the pulp and paper companies had only to add a few drops of diesel fuel into their already existing biofuel operations. This "environmental bill" had the side effect of adding greenhouse gases to the atmosphere. (Obviously, the additional pollutants were not enough to make any real difference, but the point is that the direction of greenhouse gas emissions was in opposition to the intent of the legislation.)

Taxpayers were not the only losers in this disgraceful program. Recycled pulp producers received no aid and were seriously damaged by the assistance given to the competition. Non-integrated paper mills were also severely disadvantaged. The groundwood pulp and paper producers that compete with free sheet producers (in some grades) did not receive any of this assistance; this hurt some of them very badly.

Alternative Fuel Credits — Public Companies (from *Reel Time* Nov/09 issue)

Public Company	U.S. Kraft Pulp Capacity (approx.) (short tons/yr)	Credits Accrued Through Sept. 30 ($US millions)	Estimate of Total Credits Through Dec. 31 ($US millions)
AbitibiBowater	1,100	198 *	278
Boise Inc.	1,700	135	200
Buckeye Technologies	500	92 *	130
Clearwater Paper	800	123	173
Domtar Corp.	2,900	336	496
Graphic Packaging	1,000	97 *	132
International Paper	11,000	1525	2,055
Kapstone Paper & Packaging	1,200	123	178
MeadWestvaco Corp.	2,700	281	386
P.H. Glatfelter	600	76 *	111
Packaging Corp.	1,300	129	179
Rayonier	800	141	196
Rock-Tenn	400	55	80
Sappi	1,000	77 *	117
Smurfit-Stone Container	3,900	294 *	449
Temple-Inland	2,400	153	233
Verso Paper	900	190 *	235
Wausau Paper	100	10	14
Weyerhaeuser	2,400	229	349
			$5,991

**Q3 credits estimated*

Sources: Industry Sources, ERA

Alternative Fuel Credits — Private Companies (from *Reel Time* Nov/09 issue)

Company	U.S. Kraft Pulp Capacity (approx.) (short tons/yr)	Estimated Credits Accrued Through Sep. 30 ($US millions)	Estimate of Total Credits Through Dec. 31 ($US millions)
Alabama River Pulp	900	$81	$108
Evergreen Packaging	1,000	154	205
Georgia-Pacific	7,600	1,084	1,446
Green Bay Packaging	300	39	52
Inland Paperboard	900	109	145
Interstate Paper	300	37	49
Lincoln Paper & Tissue	200	24	31
Longview Fibre	1,000	121	161
Mid-America Packaging	100	17	23
NewPage	1,700	200	280
Packaging Dynamics Corp.	100	18	24
Port Townsend Paper	200	27	36
			$2,561

Data Sources: BLRBAC; Industry Sources: Lockwood-Post

SCA AND COATED FORECAST FOR 2016

THE SCA/COATED GROUNDWOOD MARKET

During the last few years, the SCA grades (primarily out of Irving and Port Hawkesbury) have made great inroads into what had been territory reserved for coated groundwood. For example, Irving now has about 70% of its SCA capacity in very high-quality SCA+ grades. This equates to ~150,000 tons. Port Hawkesbury is in a similar situation: more than 65% of its shipments are SCA+ or SCA++ (about 235,000 annual tons).

Verso–Duluth apparently also makes very good SCA+ grades, but I do not hear about those grades as much in the market. I don't have a good estimate of the Verso SCA+ tonnage.

SCA+ grades are also available through European imports.

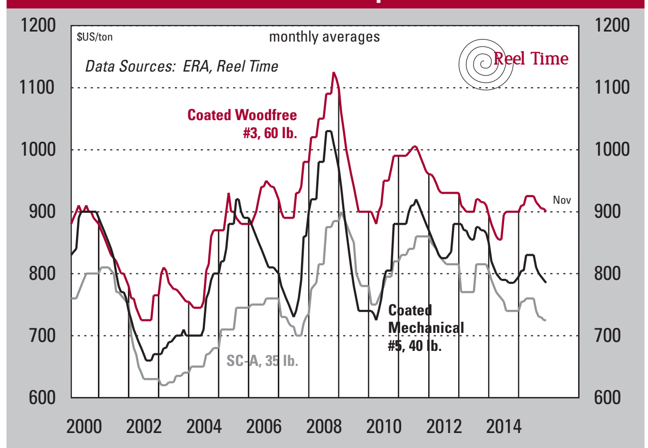
Demand and especially shipments of SCA have held up much better than coated groundwood throughout 2015 (see first two graphs on page 11). It is evident from both market intelligence and the data that this migration from coated groundwood to the higher-quality SCA grades is ongoing. It continued in 2015 and will not stop in 2016 (assuming all Canadian SCA mills still operate in 2016).

And, since these two grades can now be substituted for each other in so many applications, they have become more and more tied to one another on price.

Even prior to this "high-quality SCA+ revolution," SCA prices and coated groundwood prices tended to go up and down together, but historically there had been much greater amplitude in coated groundwood (see next graph). Today, however, these two grades will follow each other more closely than ever before. Unfortunately for SCA producers, they can't decouple from coated groundwood. The price spread between the two grades is more narrow than it was in the early years and it could narrow even further; however, strong SCA supply/demand dynamics will not allow SCA to separate itself from a weak coated groundwood market.

Therefore, the supply/demand balance of consequence is the calculation that combines both grades. Even if all of the SCA capacity in Canada were to shut down, SCA prices would not go up relative to coated groundwood. In fact, the elimination of so much of the better-quality SCA+ capacity would result in an increase in the spread between SCA and coated groundwood (given a flight to coated groundwood once SCA+ supply drops). To be clear, this analogy is just to make a point: all of the SCA capacity in Canada is not going down, and hopefully none of it will.

SCA and Coated-Paper Prices



With the current SCA/coated groundwood market still over-supplied, capacity reductions will be required to bring the market into balance and allow pricing to bounce up. However, whether the capacity removals are in SCA or coated groundwood does not matter much. Of course, as you know, any pricing improvement will also have to push through resistance existing from the overhang of European supply (more on this later).

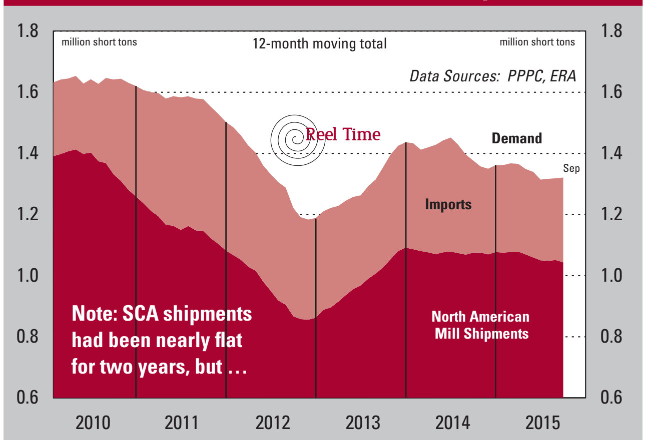
SCA AND COATED DEMAND/ SHIPMENTS AND IMPORTS

SCA

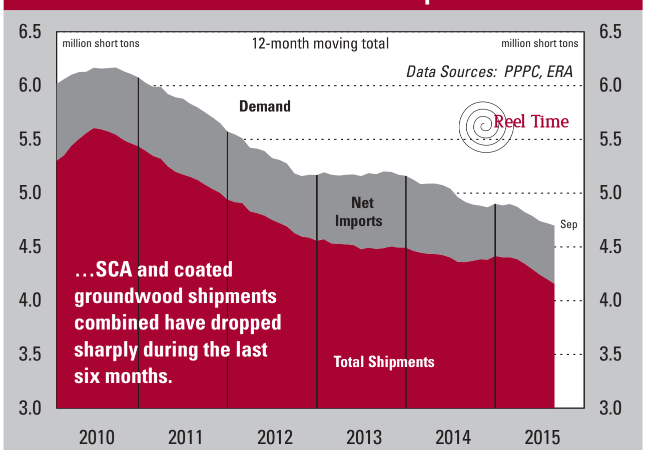
SCA Demand in 2015: North American SCA demand in 2015 has been little changed. Demand data for the last two months was a little higher (y/y), but not much. Through the first nine months of the year, SCA demand is down by 4.1% (40,000 tons). Total SCA demand will slip to about 1.3 million tons for the full year of 2015 (see the table on page 12 for much more detail).

The two components that make up North American SCA demand are domestic shipments and offshore imports. Year-to-date, domestic shipments are off by 3.2% (24,000 tons) and North American imports have slipped by 7.3% (16,000 tons).

North American SCA Demand vs. Shipments



SCA + CM Demand vs. Shipments



SCB Demand in 2015: A decrease in capacity near the end of 2014 reduced the available supply of SCB in 2015. Through September, North American SCB demand is lower by 17.4% 93,000 tons. Monthly (y/y) decreases have been consistently around this 17% level. Annual SCB demand in 2015 is on pace to reach some 533,000 tons.

Domestic SCB shipments are down by a similar 18.4%.

Offshore SCB imports appeared at one time as if they might make a move this year, but that has not happened yet. Imports through nine months are higher (y/y) by only 3,000 tons, with SCB offshore imports totaling only 14,000.

Since SCB capacity had been removed in late 2014, 2015 began with SCB tighter than SCA. Then, around mid-year, Walmart switched a large insert program from SCB to SCA. The reduction in SCB demand by Walmart also changed the supply/demand dynamics: SCB was suddenly a weaker grade than SCA.

Super-brights on SCA Machines in 2016: As was mentioned earlier, SCA is still benefiting from additional buyers substituting SCA+ for coated groundwood. Since this substitution will continue in 2016, SCA would be in a position to outperform coated groundwood again, were it not for the CVDs. The CVDs could reduce North American SCA (and SCB) shipments and demand in two ways: through the possibility of machine closures, and by Canadian producers adjusting their product mixes.

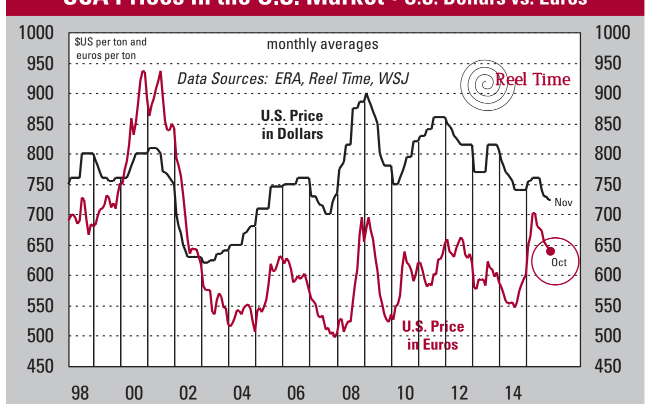
Supply will be discussed later, but right now we are assuming there will be no closures of SCA or SCB in 2016.

However, some SCA production will be moved to super-bright in order to escape payment of the CVDs (when current customers can be enticed with low prices and very high brightness). How large this volume might be is unknowable. I am going to take a wild guess that 6% (78,000 tons) of uncoated super-bright grades will be made on SCA machines in Canada in 2016.

Some SCB capacity could also be moved to high-bright or super-bright in 2016; our estimate is for a 6% (33,000-ton) swing in this direction.

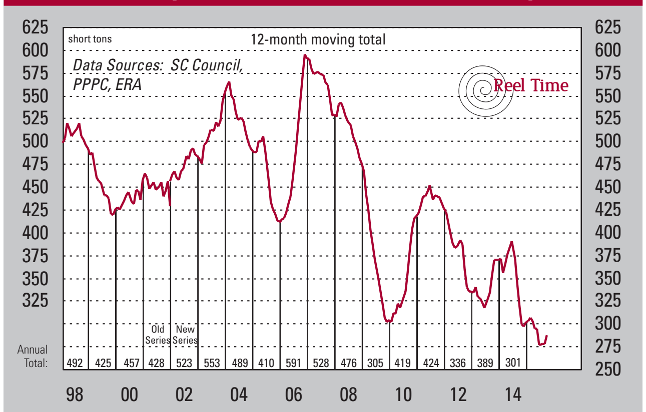
SCA Offshore Imports in 2015: In spite of the weak euro, offshore SCA imports have been a little weaker than the domestic market in 2015. (Note in the next graph, lower line, how high U.S. prices are in euros.)

SCA Prices in the U.S. Market • U.S. Dollars vs. Euros



The lack of aggressiveness regarding SCA imports so far in 2015 could be a function of restraint on the part of the Europeans during the period that the Canadian SC trade case has been ongoing — after all, it would not look good for imports from Europe to shoot up higher at the same time that a European company (UPM, by way of Madison Paper in Maine) is trying to put a halt to Port Hawkesbury's imports (and now, as it turns out, all SC imports from Canada).

SCA Imports to North America from Europe



In addition, note in the table at right that SCA offshore imports will still control 22% of "our" market in 2015. The European loss of market share so far in 2015 has been infinitesimal.

Late in the year (September 25) there was also a fire at the Laakirchen SCA mill in Austria. The fire damaged a 280,000-ton machine, but it is expected to start up again by the end of the year. This outage, if the machine does start up at year-end, will take approximately 70,000 tons of SCA shipments out of the market, and perhaps reduce North American imports of SCA from Europe a little.

SCA Offshore Imports in 2016: Based on limited market information, UPM appears to be aggressively pursuing additional business in 2016. Other SCA companies in Europe also seem more involved. This would be logical. However, to remain balanced, there is also anecdotal information that implies that the European SCA market — with the Laakirchen machine temporarily down — is fairly balanced. It will be a number of months before the data tells us what is actually occurring.

Apart from being more aggressive on pricing, the door will open for European SCA if any Canadian SCA capacity goes down, or even if the machines stay up but Canadian producers lose interest in supplying SC to the United States. In our *Reel Time* forecasts, it is assumed that all Canadian SC capacity will continue to operate, but this is definitely a risk to the accuracy of our outlook.

Last, some U.S. buyers may feel at risk with business that has been placed in Canada, and could choose to share that business with European competitors.

SCA Shipments to North America • (000 short tons)

Year	From N.A.	From Europe	Total	% European Supply	
1984	250	245	495	49.5%	
1985	240	355	595	59.7%	
1986	240	280	520	53.8%	
1987	250	366	616	59.4%	
1988	505	414	919	45.0%	
1989	570	384	954	40.3%	
1990	671	344	1,015	33.9%	
1991	707	274	981	27.9%	
1992	681	356	1,037	34.3%	
1993	752	461	1,213	**38.0%**	Average: 39%
1994	812	489	1,301	**37.6%**	
1995	799	528	1,327	**39.8%**	
1996	676	**445**	1,121	**39.7%**	
1997	712	516	1,228	**42.0%**	
1998	829	504	1,333	**37.8%**	
1999	1,034	450	1,484	30.3%	
2000	1,071	458	1,529	30.0%	
2001	1,307	456	1,763	**25.9%**	Average: 25%
2002	1,505	483	1,988	**24.3%**	
2003	1,503	**553**	2,056	**26.9%**	
2004	1,559	489	2,048	**23.9%**	
2005*	1,703	411	2,114	19.4%	
2006*	1,452	591	2,043	28.9%	
2007	1,686	528	2,214	23.8%	
2008	1,610	476	2,086	22.8%	
2009	1,267	305	1,572	19.4%	
2010	1,205	419	1,624	25.8%	
2011	1,074	424	1,498	28.3%	
2012	854	336	1,190	28.2%	
2013	1,065	370	1,435	25.8%	
2014	1,053	302	1,355	22.3%	
2015 (est.)	1,020	287	1,307	22.0%	
2016 (fcst)	**834**	**330**	**1,164**	**28.4%**	

**There was a strike in Finland in 2005 and a strike at NewPage Port Hawkesbury in 2006 that impacted the data for those years.*

Note: This table does not include North American SCA exports.

Sources: SC Council, PPPC

Imports of SCA from Europe will end 2015 (based on the current pace of imports) at 287,000 tons. The *Reel Time* 2016 forecast is for a 15% increase in SCA imports from Europe — up to about 330,000 tons.

SCA Shipments and Demand Forecast for 2016: On the surface, 2016 looks like a very bad-volume year for North American SCA producers. It seems likely that offshore imports will increase, the secular decline will continue, and SCA producers will try to switch out some SCA for super-bright grades.

If the secular decline were to take out 5.0% of demand, with North American SCA imports growing by 15% and 78,000 tons of SCA moving to super-bright, then overall SCA demand would fall by 143,000 tons (11.0%) and North American shipments would drop by 186,000 tons (18.3%).

Wow! Of course, to the degree that current customers are convinced to move from SCA to super-bright (our estimate is 78,000 tons), the situation is not nearly that bleak. Also, it might turn out that imports grow by less than our 15% projection, so there is reason to hope that conditions will end up better than has been forecasted here. See the table on page 12 for actual 2016 estimates of SCA shipments, imports and demand.

SCB Demand Forecast for 2016: The *Reel Time* forecast is for the secular decline to take out only 3.0% (16,000 tons) of SCB demand, and for imports to grow by just 10,000 tons. Based on those two factors, North American SCB demand would fall by 26,000 tons (4.8%).

The other factor of consequence, and the one even harder to forecast — is how much high-bright or super-bright will replace SCB on Canadian SCB machines. We are guessing 6% (33,000 tons).

To the degree that this forecast is accurate, SCB demand would fall by 59,000 tons (11.0%) to some 474,000 tons.

Coated Demand and Shipments

2015 Coated Demand and Shipments: Monthly (y/y) declines in 2015 coated shipments and demand will be shown in a table (page 14, bottom right) that is part of the discussions that follow. You know the basics: coated shipments are much worse than demand, but demand is not good either. A quick summary is provided next before additional details are offered.

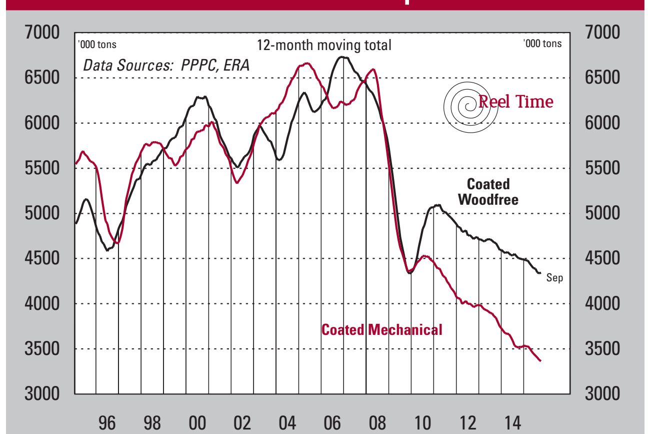
Coated Groundwood

- Through September, the PPPC shows **coated groundwood demand** down 6.7% (174,000) tons. At this percentage rate of decline, the 2015 loss in North American coated groundwood demand would be about 235,000 tons, and end the year at 3,300,000 tons.
- North American **coated groundwood shipments** have plunged by 10.8% (266,000 tons) year-to-date. Coated groundwood shipments are on pace to end the year down 360,000 tons to about 2,980,000 tons.

Coated Free Sheet

- PPPC **coated free sheet demand** data year-to-date is off by a less reprehensible 4.0% (134,000 tons). This same (y/y) percentage decline in Q4/15 would result in a coated free sheet demand loss in 2015 of 180,000 tons, to an annual total of 4,300,000 tons.
- North American **coated free sheet shipments** are down by 6.9% (193,000 tons) so far in 2015. At that rate, the total 2015 fall in coated free sheet shipments would be 258,000 tons, to an annual total of 3,470,000 tons.

North American Coated Paper Demand



Review of Demand Factors: In our April 2015 *Reel Time,* we reviewed the sources of demand that control the SC and coated groundwood markets. At the bottom of page 2 of that issue, the following was concluded:

Summary: *Demand for most SCA and coated end uses seems to be eroding at a moderate rate; we can use the PRIMIR forecast of 3%–5% in annual declines as a reasonable estimate. In comparison to newspaper publishing and even magazine publishing (which is up next), these 3%–5% declines seem "modest." Actually, however…at a 4% rate of decline, market size will decrease by one-third in a decade.*

And then the conclusion for printed magazines is on page 5.

The demand decline for magazine paper in 2014 must have been greater than 10%, and possibly as steep as 15%.

Then SC and coated groundwood demand data was analyzed in detail in our July *Reel Time*. At the time, we were trying to reconcile the relatively good Q4/14 and Q1/15 demand data with the very poor second quarter.

North American Coated Shipments and Demand • 2015 monthly

Source: PPPC	COATED GROUNDWOOD Shipments	COATED GROUNDWOOD Demand	COATED FREE SHEET Shipments	COATED FREE SHEET Demand
January	-3.7%	-5.3%	-6.8%	-5.0%
February	-0.7%	+2.2%	-3.2%	-0.1%
March	-4.9%	-6.0%	-4.8%	-8.4%
April	-13.0%	-11.1%	-10.0%	-6.7%
May	-15.3%	-9.5%	-10.0%	-6.9%
Jan–May (y-t-d)	-8.0%	-6.0%	-7.0%	-3.6%
Jan–May (y-t-d) (AF&PA comparison)	-10.8%	-9.9%	-5.8%	-0.4%

2015 Coated Operating Rates • Shipments-to-capacity

Source: PPPC	COATED GROUNDWOOD	COATED FREE SHEET
January	98%	87%
February	98%	88%
March	97%	90%
April	90%	84%
May	84%	76%

Upon analyzing the data, it seemed likely that the steep second-quarter declines were at least partially a function of customers burning off excess inventory. After consumer inventories returned to lower levels, it was assumed that demand declines would not be so steep, i.e., that declines more representative of the previous four years would reassert themselves (see the table at top right for 2011–2014 data).

North American Coated Shipments and Demand • 2011–2014

Source: PPPC	COATED GROUNDWOOD Shipments	COATED GROUNDWOOD Demand	COATED FREE SHEET Shipments	COATED FREE SHEET Demand
2011	-7.6%	-8.6%	-4.1%	-2.8%
2012	-4.1%	-2.3%	-3.9%	-3.0%
2013	-8.1%	-6.6%	-2.3%	-2.4%
2014	-1.8%	-4.9%	-2.6%	-2.3%
2011–2014 (average)	**-5.4%**	**-5.6%**	**-3.2%**	**-2.6%**

So how did it turn out; was the assumption that demand declines would gravitate back in line with 2011–2014 correct or not? Well…yes, yes, and not really. (See the three items and the table below.)

- It is true that the third quarter improved quite a bit from the second, so we got that right.
- In addition, the third-quarter data for coated free sheet looks as if it is falling pretty close in line with the 2011–2014 level, so that too is a positive. (There was an anomalous and severe coated free sheet demand decline in July, but that was way out of line with the other three of the last four months so it is being minimized.)
- However, while the Q3 coated groundwood demand data is not as horrible as Q2, there was a step down in coated groundwood demand from the 2011–2014 level. We can't say for certain that this new lower level will continue, but it is the trend at present (see the next table, updated from our July issue).

North American Coated Shipments and Demand • 2015 monthly

Source: PPPC	COATED GROUNDWOOD Shipments	COATED GROUNDWOOD Demand	COATED FREE SHEET Shipments	COATED FREE SHEET Demand
January	-3.7%	-5.3%	-6.8%	-5.0%
February	-0.7%	+2.2%	-3.2%	-0.1%
March	-4.9%	-6.0%	-4.8%	-8.4%
April	-13.0%	-11.1%	-10.0%	-6.7%
May	-15.3%	-9.5%	-10.0%	-6.9%
June	-15.0%	-8.4%	-6.4%	-2.2%
July	-15.2%	-7.0%	-11.8%	-9.6%
August	-16.5%	-8.6%	-7.4%	-2.8%
September	-10.3%	-5.1%	-1.4%	+1.6%
Jan–Sep (y-t-d)	-10.8%	-6.7%	-6.9%	-4.0%
Jan–Sep (y-t-d) (AF&PA comparison)	-14.0%	-10.2%	-6.4%	-1.7%

The average annual PPPC coated groundwood demand decline of 2011–2014 was 5.6%. The PPPC coated groundwood demand decline through September 2015 is 6.7%.

The average annual PPPC coated free sheet demand decline of 2011–2014 was 2.6%. The PPPC coated groundwood demand decline through September 2015 is 4.0%.

Therefore, demand has actually not been a great deal worse in 2015 (year-to-date) than the average of the previous four-year period, but this is partly because Q1/15 was relatively strong. (Shipments, of course, are another story. Shipments have been much worse than demand and much worse than the previous four-year period due to the growth in net imports.)

Our plan is to take another closer look at the specific end uses that make up publication paper demand in one of our issues next spring.

Note on Demand Data: The AF&PA data is provided for comparison. Compared to the PPPC, the AF&PA shows a much larger 2015 year-to-date decline in coated groundwood demand (-10.2%) and a much lower decline in coated free sheet demand (-1.7%). The divergence between the two organizations can be partly reconciled by looking at the total coated demand data for both organizations. Total coated demand (year-to-date) has declined by 5.2% (PPPC) or 5.6% (AF&PA). Therefore, the problem with the data, it appears, is that some shipments that the PPPC counts as coated groundwood are counted as coated free sheet by the AF&PA.

Coated Demand Forecast for 2016: The electronic revolution will continue to run its course and result in less usage of printing paper grades in 2016. The best we can do, regrettably, in attempting to forecast coated demand, is to look at the trends, in combination with available supply and the expected impact of the pricing level. (We are not forecasting extreme economic activity — a boom or a bust — that could affect printing paper demand significantly in 2016.) At some point, it is reasonable to expect that the secular declines in the coated grades will slow considerably, but we are not there yet.

If we go back to our data review of 2016, North American coated groundwood monthly demand in the third quarter averaged (y/y) a decline of 6.9%. This is consistent with negative media reports of weakness in catalogs, inserts, and especially magazines.

Our 2016 forecast is for a 6.5% decline in coated groundwood demand. Whether this is correct or not, the month-by-month data will not be consistent. The first three months of 2016 will likely show steep declines, and the second quarter will show more moderate declines. A 6.5% decline in coated groundwood in 2016 would equate to a loss of about 215,000 tons.

Reel Time is forecasting a 3.3% decline in 2016 coated free sheet demand. This forecast is in between the 2011–2014 average decline of 2.6% and the 4.0% decline of 2015 (through September). A 3.3% decrease in coated free sheet demand in 2016 would equal about 142,000 tons.

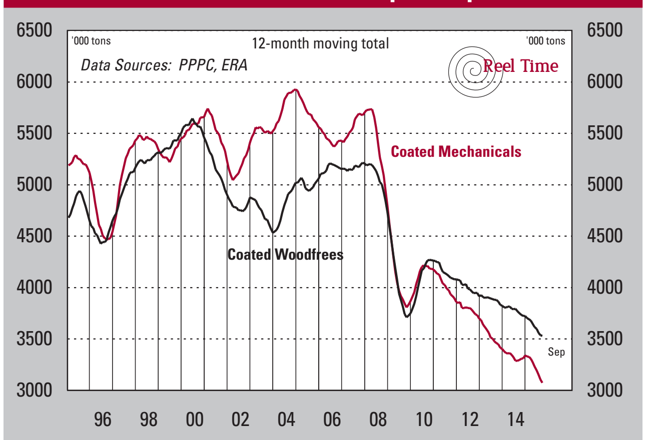
Review of Coated Shipments in 2015: The table to which we have been referring (page 14, bottom right) tells us that PPPC shipments of coated groundwood have plunged by 10.8% (266,000 tons) through September 2015. This decline is 4.1% (123,000 tons) steeper than the 6.7% (174,000-ton) drop in demand. An increase in net imports accounts for the additional weakness in shipments over demand. (Almost all of that increase in net imports was a result of expanded offshore imports, with only 9,000 tons due to a decline in offshore exports.)

Defining Net Coated Imports: *Since there are more North American imports of coated grades than exports, we have "net coated imports." If there were more exports than imports, there would be "net coated exports." In North American newsprint data, for example, we have net newsprint exports.*

Therefore, North American net coated imports will increase when imports increase or when exports decrease.

Similarly, PPPC shipments of coated free sheet have dropped by 6.9% (193,000 tons) through September 2015. This decline in shipments is 2.9% (59,000 tons) steeper than the 4.0% (134,000-ton) drop in demand. According to the PPPC data, the "extra" loss in shipments of 2.9% resulted from imports increasing by 21,000 tons and exports declining by 36,000 tons. So, in coated free sheet, the loss of exports was much more of a factor than rising imports.

North American Coated Paper Shipments



Coated Shipments for 2016: In effect, of course, this analysis of coated shipments is just a projection of net imports on top of demand declines. Will net imports increase or decrease in 2016? I don't think any of us will get that general question wrong. Even if coated imports in Q4/15 and all of 2016 were flat with Q3/15, net imports in 2016 would still be substantially higher (y/y), due simply to the growth in net imports that had already occurred by Q3/15.

But even more important is the fact that offshore imports are still trending higher.

The other aspect of "net North American imports" is offshore exports. Coated exports are worth talking about, but the numbers are not really big. Through September, offshore exports of coated groundwood are down by 9.5% to 82,000 tons, and coated free sheet exports are lower by 30.3% to 86,000. With the dollar so high, offshore exports will probably continue the downtrend in 2016.

Therefore, with coated imports rising and coated exports (likely) decreasing again in 2016, it seems almost certain that shipments next year will again be lower than demand. Obviously, that is a big problem for manufacturers trying to keep their machines running and make some positive financial contribution.

We will now review and make projections for coated imports and exports in 2016, before returning to offer our shipments forecast.

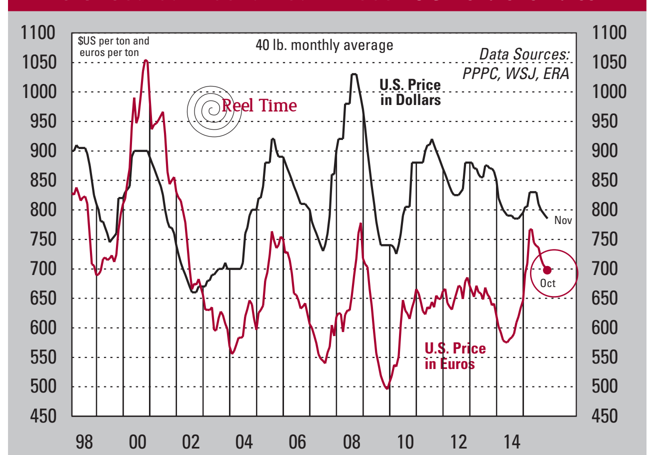
Coated Imports for 2016: The strong dollar has made exports from Europe much more attractive in 2015 and this will be the case again in 2016. I understand that at least one paper analyst believes the dollar will weaken in 2016 and change the import dynamics somewhat. That is certainly possible, but our position has been that the strong dollar cycle will last three to five years (or perhaps even longer).

The two graphs below show the impact of the strong dollar from the perspective of those who live in the euro world. Although U.S. prices are very low for both coated grades, U.S. prices when converted to euros are near the highest levels European exporters have enjoyed since 2002.

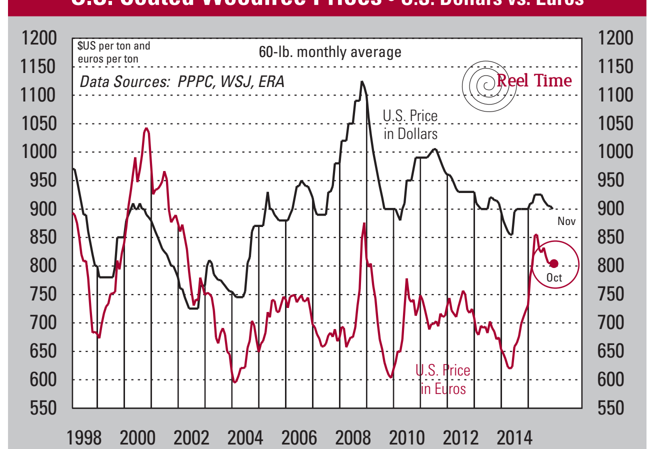
Another factor that might encourage additional imports in 2016 is the repricing of currency hedges that will now be reflecting the stronger U.S. dollar.

Coated groundwood imports are showing a lot of strength lately — up 58% (y/y) in September and now up 35% (83,000

U.S. Coated Mechanical Prices • U.S. Dollars vs. Euros



U.S. Coated Woodfree Prices • U.S. Dollars vs. Euros



tons) year-to-date. Coated free sheet is not doing too much: it's up by only 3% (21,000 tons) through September.

There is no space in this issue for a deep analysis of coated imports. Briefly, however, it is not as easy for the Europeans to export to the U.S. at it once was. Obviously, the market is much smaller; that goes without saying. In addition, the two market segments best suited to imports were magazine publishing, followed by catalogs. These two end uses tend to have long lead times and stable roll sizes. However, magazine publishers, from a print standpoint, are only a shadow of what they once were. Catalogers have also been hit hard, especially on page count. As a result, it is much harder to find large buyers that offer long lead times.

This is even more of a problem for coated free sheet imports in roll form. The coated free sheet roll business does not have many large customers with stable roll sizes. This is why, in terms of coated free sheet, our analysis in the August *Reel Time* indicated that U.S. producers controlled 95% of the roll business in North America.

Of course, the coated free sheet, sheet-fed business is perfect for exporters to the United States. However, importers already control over half of that business, so it is not clear whether there is much more room to grow.

On the other hand, lower prices can, in many instances, encourage buyers to become more flexible. That is why coated groundwood imports are growing again.

In addition, when capacity does come out of the SC or coated market, and price increases are attempted, coated supply from Europe will be available "at the old price." This will make it hard for U.S. producers to raise prices as quickly and completely as they could had the euro already moved back up to $1.30 or so.

In summary, coated imports (especially coated groundwood) are in the process of moving higher. How long that trend continues is not known but it is speeding up at this time rather than slowing down. In addition, coated imports will likely spike up when price increases are attempted in 2016.

Reel Time is projecting that coated groundwood imports in 2016 will increase by 25% (just over 100,000 tons), and that coated free sheet imports will grow by 5% (50,000 tons).

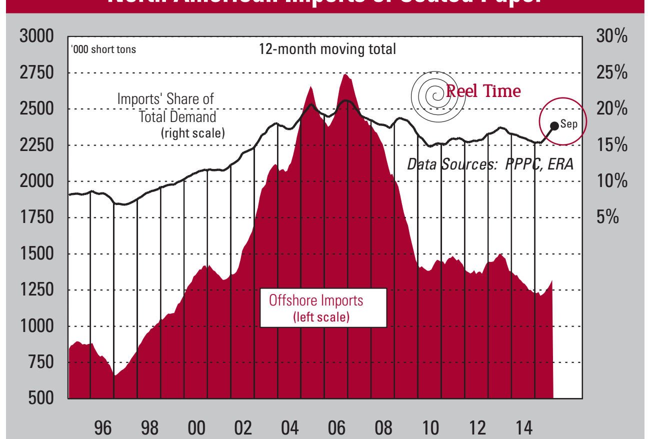
Getting back to offshore exports, our official forecast is for coated groundwood exports to fall by 10,000 tons and coated free sheet to drop by 20,000 tons.

Coated Shipments Forecast for 2016: To the degree that our import and export forecasts are accurate, coated groundwood shipments would decline by 215,000 tons (due to lower demand) and 110,000 tons (due to higher net imports). Therefore, coated groundwood shipments would fall by 325,000 tons in 2016, a decline of roughly 11.0%.

In addition, coated free sheet shipments would decline by 142,000 tons (due to lower demand) and 70,000 tons (due to higher net imports). Therefore, coated free sheet shipments would fall by 212,000 tons in 2016, a drop of about 6.0%.

In spite of our contention that it is harder for Europeans to export coated grades to North America than ever before, the European coated market share in North America has certainly not suffered for it. If our forecasts are in the neighborhood of being correct, then the European coated share of the North American market will be at or approaching all-time highs by the end of 2016 (see next graph).

North American Imports of Coated Paper



PRICE FORECASTS FOR 2016

Current Market Conditions

The SCA market is under pressure at the present time. That pressure is not primarily the result of less interest in SCA, but is coming from coated groundwood pushing down on top of SCA (and SCB as well). In addition, certainly coated groundwood, and perhaps SCA, are being pressured by growing imports.

Coated free sheet supply/demand problems are not as severe as those of coated groundwood and SCA, but they have not gone away either.

How Oversupplied?

SCA/Coated Groundwood: The Verso closure of PM#2 at Jay, ME took out 150,000 tons of coated groundwood. In addition, Catalyst's shutdown of PM#12 at Rumford (110,000 tons of CGW/CFS mix) probably helped help a little as well. (However, Catalyst says it is producing more paper at Rumford now than NewPage did when PM#12 was running.)

Compared to the capacity reductions, North American coated groundwood shipments in 2015 will fall by about 360,000 tons; SCA shipments will be down by some 23,000 tons. Obviously, more capacity removals are necessary to balance the SCA/coated groundwood market.

Mill inventories are a supply item; if they are high, paper companies will eventuality have to lower them by selling more paper than they've actually produced, or by taking market-related downtime. As related to this forecast, coated groundwood mill inventories appear to be under good control: the PPPC data suggests they are only 13,000 tons higher than last year at this time (and they were pretty low then). The AF&PA data also has coated groundwood mill inventories on the low side. Coated groundwood mill inventories appear to be a non-factor for this forecast.

Coated Free Sheet: The Q4 closure at Verso–Wickcliffe (280,000 tons of coated free sheet) took pressure off Verso, given its low coated free sheet backlogs at the time. In theory, that closure should have balanced supply/demand in coated free sheet, since shipments will fall by less than that in 2015 (about 259,000 tons). Even though the coated free sheet market did not demonstrate good strength following the closure, there should not be much excess capacity at the current time.

Of course, the high volume of *uncoated* free sheet (in roll form) being produced on coated free sheet machines and sold by Appleton and Verso make it difficult to judge what full coated free sheet capacity *is*, and how important — or unimportant — it is to reach full capacity. The volume of coated free sheet produced does not come close to full capacity of the coated machines, since over 300,000 tons per year of uncoated free sheet is used to fill the holes.

How the high ADDs and CVDs on uncoated free sheet will impact coated free sheet companies is in question right now. Three possibilities can be imagined. The first is most likely, and the third is what I would do immediately if I owned an efficient coated free sheet machine (with a flexible production floor) in the east or Midwestern part of the United States.

1. Since uncoated free sheet rolls and cut-size prices have tended to move up and down together, the higher prices of cut-size that will be possible due to the duties will likely help the coated free sheet producers with roll volumes and prices — and therefore profits.
2. However, uncoated free sheet roll products are not protected by the duties, so exporters to the U.S. could jump into those sub-markets and offer very competitive prices (due to the currency advantage and the fact that U.S. prices have remained so relatively high). What will make this growth in imports difficult, however, is that there are relatively few large buyers of uncoated free sheet rolls. In addition, the overall volume of white rolls is not nearly as great as cut-size; it's just not a very big market.
3. The big, revolutionary strategy now open to coated free sheet producers is to spend big bucks to put in cut-size converting equipment and get into the obscenely profitable cut-size business. Since the ADDs will knock out most cut-size imports, the door is open. (Actually, the planning can start, but the final duties and confirmation of market damage are still on the docket.)

Switching subjects, coated free sheet mill inventories are not a huge mill problem, but they are somewhat high. (This is a hint that excess supply is troubling the market.) The PPPC has September coated free sheet mill inventories 51,000 tons higher than September 2014, while the AF&PA puts these inventories 70,000 tons higher.

Canadian CVDs: Implications for Both Capacity and Pricing of SCA

First off, I am writing this report as if the final decision has already been made, even though the 2015 part of this trade action has not yet run its course. We assume that the ITC will rule (December 4) that the U.S. market is being "damaged' by SC imports from Canada, but that decision has not been made yet. There is still some hope.

Nevertheless, assuming the worst, the next table is repeated from earlier in the report. The enormous CVDs will make it very difficult for Canadian producers to survive. In fact, there is no doubt that if SC manufacturers in Canada believed these CVDs would remain in place for five years (without recourse to get their money back), they would all shut their doors.

CVDs on Canadian SCA Producers

Company	Preliminary CVD Rate	Final CVD Rate	Cost/Ton (US$/est.)	Annual Cost (US$ millions/est.)
Port Hawkesbury	20.33%	20.18%	$140	$50
Resolute	2.04%	17.87%	125	25
Irving	11.19%	18.85%	135	50
Catalyst	11.19%	18.85%	125	16

Note: The cost/ton and annual cost estimates are based on the final CVD rates and very rough estimates of grade mix and pricing. These estimates could also change to the degree that Canadian producers decide to produce more high-bright grades and less SC.

In addition, if the U.S. dollar was not so strong, closures would be inevitable (in the table at top right, note how very high U.S. prices are in Canadian dollars).

Port Hawkesbury may be in a better cash-cost position than its competition, i.e., perhaps its margins can stay above cash costs. However, I would guess that the other three producers will be losing $40–$80/ton for every pound of paper sold into the United States.

Of course, Catalyst and Irving should get all of their money back eventually, but the millions in CVDs will be adding up quickly in the meantime.

SC-A (35#) Pricing in U.S. & Canadian Dollars

Date	Value Canadian Currency vs. U.S. Dollar	U.S. Pricing	U.S. Pricing Converted to Canadian Dollars
January 1, 2001	0.67	810	**1,209**
January 1, 2002	0.63	700	**1,111**
January 1, 2003	0.64	620	**969**
January 1, 2004	0.77	650	**844**
January 1, 2005	0.83	710	**855**
January 1, 2006	0.85	765	**900**
January 1, 2007	0.86	730	**849**
May 28, 2007	0.93	715	**769**
Nov. 5, 2007	1.07	730	**682**
January 1, 2008	1.02	775	**760**
January 1, 2009	0.82	900	**1,098**
January 1, 2010	0.95	750	**789**
January 1, 2011	1.00	830	**830**
January 1, 2012	0.98	850	**867**
January 1, 2013	1.00	770	**770**
January 1, 2014	0.94	805	**856**
January 1, 2015	0.86	755	**878**
November 7, 2015	**0.76**	**725**	**954**

low points

Resolute probably expects to get its money back too, but how do those appeals work? The Canadian SCA companies, and Canada in general, had no power to effect change or obtain balance in these initial proceedings. Will balance be possible in future appeals — effective balance that will return funds to Resolute? If at some point Resolute believes the probability of a positive future resolution is not good, one would think that both mills would be closed.

Since the final CVDs have been applied, Canadian SC companies are being more resistant to additional price declines. SCA and SCB price increases were even considered, but not announced — at least not yet. Unfortunately, the more aggressive on price Canadian SC companies are, the more business they will eventually lose. U.S. buyers have sympathy for Canadian SC companies, but, when the rubber meets the road, price is obviously still the major factor.

In summary, we hope there is a way through this for the Canadian companies, and there may be, but continued operation of all SC mills in Canada is at risk.

Capacity Removals Required to Affect Price Increases

SC/Coated Groundwood: As reviewed earlier, shipments of SCA and coated groundwood combined will fall steeply — by about 383,000 tons this year — but only some 200,000 tons of capacity was removed. It is estimated that another 200,000–250,000 tons of capacity will need to be removed to balance the U.S. market.

However, that is just the capacity removal needed to balance the market late in 2015. In 2016, coated groundwood shipments are projected to plunge by another 325,000 tons.

(For historical context, the next table and the one in the right column show the SC and coated paper machines shut down since 2007.)

SC Closures, Permanent and Indefinite • 2007–2014

Supplier	Mill	Grade	Official Capacity (tons)	Date
Kruger	Wayagamack	Soft-Nip	68,000	Sep/07
Kruger	Trois-Rivières #5	SCC	77,000	Nov/07
Catalyst	Elk Falls #2	Soft-Nip	160,000	Q1/09
St. Marys	Sault Ste. Marie	SCB	100,000	Dec/09
Kruger	Trois-Rivières	SCC	72,000	Jun/10
Resolute	Kenogami	SCB	80,000	Dec/11
Resolute	Grand Mere	SCB	135,000	Nov/12
Resolute	Laurentide	SCB	210,000	Oct/14
Subtotal			**902,000**	
AbitibiBowater	Donnacona	SCA	175,000	Feb/08
Katahdin	Millinocket	SCA	190,000	Jul/08
AbitibiBowater	Fort Frances #6	SCA	80,000	Dec/09
St. Marys	Sault Ste. Marie	SCA	140,000	Mar/11
Verso	Sartell #1 & #2	SCA	100,000	Dec/11
Subtotal			**685,000**	

Notes:

Resolute closed the Grand Mere mill in November 2012 several months after reopening the Dolbeau SCB machine.

Also note that the 415,000-ton Port Hawkesbury machine was reopened in October 2012 with a new capacity of 370,000 tons.

Coated Free Sheet: As mentioned earlier, there probably isn't a lot of excess supply in this segment. However, with inventories somewhat high also, that will add to the problem a bit. Of course, the ongoing secular decline, as well as growth in net imports, will continue to erode coated free sheet shipments in 2016; the *Reel Time* estimate is for coated free sheet shipments to fall by another 212,000 tons.

North American Coated Capacity Reductions • 2007–2014

Company/Mill Location	Capacity (000 tons)	Grade	Date Closed
NewPage — Luke, MD	100	CFS	Jan/2007
Tembec — St. Francisville, LA	325	CFS	Jul/2007
UPM — Miramichi, NB	495	CGW	Aug/2007
Domtar — Hull, QC	100	CFS	Oct/2007
Fraser Papers — Madawaska, ME	80	CGW	2008
NewPage — No. 11 Rumford, ME	90	CGW/CFS	Feb/2008
NewPage — Niagara, WI	230	CGW	Jul/2008
NewPage — No. 95 Kimberly, WI	130	CFS	May/2008
NewPage — No. 96 and 97 Kimberly, WI	500	CGW/CFS	Aug/2008
Verso — Bucksport, ME	85	CGW	Sep/2008
AbitibiBowater — Covington, TN	75	CGW	Nov/2008
Sappi — Muskegon, MI	170	CFS	Mar/2009
Kruger — Trois-Rivières, QC	70	CGW	Oct/2009
Domtar — Columbus, MS	235	CGW	Apr/2010
Kruger — Trois-Rivières, QC	90	CGW	Jun/2010
NewPage — Whiting, WI	250	CGW	Feb/2011
Verso — Bucksport, ME	90	CGW	Oct/2011
Smart Papers — Hamilton, OH	45	Specialty	Feb/2012
Verso — Sartell, MN	190	CGW/SCA	May/2012
Resolute — Catawba, SC	150	CGW	Jun/2012
IP — Courtland, AL	185	CFS/C1S	Nov/2013
FutureMark — Alsip, IL	160	CGW	Sep/2014
Verso — Bucksport, ME	350	CGW/CFS	Dec/2014
Catalyst — PM# 12 Rumford, ME	**110**	**CGW/CFS**	**May/2015**
Verso — PM# 2 Jay, ME	**150**	**CGW**	**Oct/2015**
Verso — Wickliffe, KY	**280**	**CFS**	**Oct/2015**
Total	**4,735**		

It should also be kept in mind that there is significant substitution between the coated groundwood and coated free sheet grades. Therefore, if enough capacity were to be eliminated from the SCA/coated groundwood market to strengthen it considerably, then a coated free sheet capacity elimination may not be necessary in order for coated free sheet prices to rise.

The opposite dynamic is also in play. It is very difficult — bordering on impossible — for coated free sheet companies to remove enough coated free sheet capacity to increase prices significantly as long as coated groundwood is still weak, because, as coated free sheet prices rise, demand is siphoned off by lower-priced coated groundwood.

For reference, tables follow on page 21 that provide North American capacity for the SC and coated grades.

Maximum North American SCA Capacity • By company

Company	Short tons	Market Share
Port Hawkesbury	390,000	31.7%
NewPage	240,000	19.5%
Irving	220,000	17.9%
Madison	220,000	17.9%
Resolute	160,000	13.0%
Total	**1,230,000**	**100.0%**

U.S. capacity 35.7%

Notes:

North American SCA capacity does not include SC produced on coated machines.

New capacity estimates have been made to accommodate lower basis weights. This data will be revised as we learn more.

In theory, max capacity would be 95% of these estimates.

North American SCB and SCA Capacity • By company

Company	SCB	SCA
Port Hawkesbury	50,000	340,000
NewPage	—	240,000
Madison	20,000	200,000
Irving	210,000	220,000
Resolute	155,000	160,000
Catalyst	160,000	—
Total	**595,000**	**1,160,000**

Notes:

Since Port Hawkesbury and Madison are currently producing a substantial volume of SCB, we separate out SCB from SCA in the table above. Other SCA companies also make SCB as needed.

New capacity estimates have been made to accommodate lower basis weights.

In theory, max. capacity would be 95% of these estimates.

Proposed (Q4/15) N.A. Coated Mechanical Capacity • By company

Company	000 tons	Market Share
Catalyst	860	30%
The new Verso	665	23%
Resolute	550	19%
UPM	390	13%
Kruger	275	9%
Evergreen Packaging — Pine Bluff	180	6%
	2,920	**100.0%**

Proposed (Q4/15) N.A. Coated Free Sheet Capacity • By company

Company	000 tons	Market Share
The new Verso	1,770	46%
Sappi	1,240	32%
Appleton Coated	390	10%
Catalyst	200	5%
West Linn	250	7%
	3,850	**100.0%**

78%

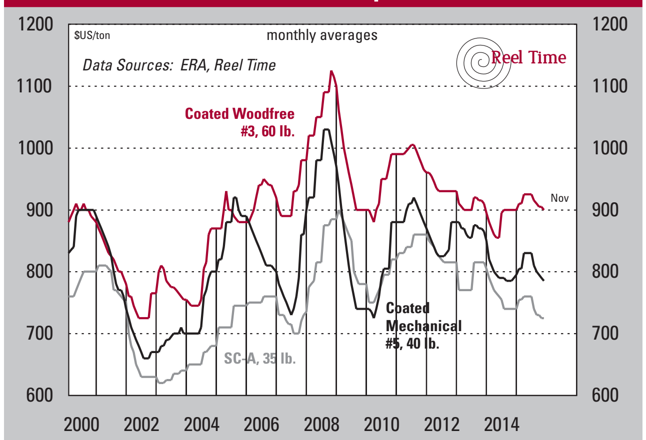
Pricing Up-cycles Ain't What They Used to Be

Long pricing cycles no longer occur. The FutureMark and Bucksport closures kept the markets balanced for only about six months.

Not only are cycles short, but price increases, by historical standards, are anemic. Prices hardly rose at all as a result of the 2014 coated groundwood closures, even with a six-month long balanced market.

Compare that performance with earlier cycles during the last 15 years. Even during this century — a very poor period for coated paper companies — coated groundwood pricing cycled up by $200/ton or more on three occasions! At present, it appears unlikely that a future up-cycle will even move prices up by $100/ton.

SCA and Coated-Paper Prices



This inability to obtain periods of positive pricing and strong profits have serious financial repercussions, of course. Manufacturers wonder why they are still in this business.

The excess supply from Europe during this strong dollar period makes the situation even more difficult, adding another pressure that will tend to shorten cycles and limit price rises.

Therefore, what we are stuck with are short periods of time (following capacity removals) in which prices rise above cash costs (of the higher-cost operations).

In a sense, of course, this process has been going on since the secular decline began in SCA and coated around 2006. However, things are different now. Until about three years ago, puny, short-lived pricing cycles never occurred.

SC and Coated Paper Price Forecasting in Modern Times

There are no more long and steep pricing cycles to forecast in the SC and coated grades. What's left is to try to figure out where the cash-cost bottoms are, and look for hints about when the next wave of closures will occur. As has been the case during the last three years, however, prices will not rise dramatically off the cash-cost bottom. Prices will drag along near the bottom, bounce up, and then drift back down and, upon reaching the bottom, drag along again for a while.

Consumer Inventories

In days of yesteryear, consumer inventories played a major role in paper pricing cycles. It was the buildup and then the depletion of massive consumer inventories that caused pricing cycles to last so long (15–18 months). Today, there are not many buyers still willing and able to manipulate inventories very much. Consumer inventories remain a factor, but not a huge one.

At the present time, with paper so readily available and prices falling, we would expect buyer inventories to be very low. That pent-up demand will be a good thing once capacity is removed and prices begin to move up. However, even this pent-up demand will probably not be able to keep the market strong for longer than about six months.

SCA and Coated Pricing Forecast for 2016

All grades currently appear to be under some pressure. Barring a significant closure announcement(s), pricing for most (or all) grades will be at least a little lower by January. Pricing is already below the levels most analysts had pegged for cash-cost bottoms (for SCA and coated groundwood), so one would imagine that prices can't go substantially lower, and that closures will follow.

Our forecast, therefore, is for SCA and/or coated groundwood capacity closure announcements to be made by the end of Q1/16. Either at that time or whenever capacity is actually removed, prices will rise by $20–$80/ton. How steep the increase is and how long it lasts will depend on the volume of capacity removed, i.e., whether it is enough to clean up the market. In other words, did the capacity removal allow mill inventories to reach bottom and still build long backlogs? Did it placate European exporters to the U.S. with a few more tons without undermining the increase?

As opined previously, even if the next capacity announcements lead to a large removal of capacity, the strong market will not likely last for more than six months. The only market dynamic that would enable paper companies to hold and build on any initial price increases would be further capacity removals, and this time those would have to be proactive — and proactive capacity removals in the SCA and coated grades, while technically possible, are highly improbable.

QUARTERLY PRICE FORECASTS FOR 2016

Reel Time **Price Forecast for 2016**

Reel Time	Newsprint 30#	SCA 35#	Coated Groundwood 40#	Coated Free Sheet 60#
Current	485	725	785	900
Q1/16	500	715	775	890
Q2/16	520	745	795	910
Q3/16	530	775	815	930
Q4/16	530	765	800	910
Annual 2016	520	750	796	910